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SUBJECT: KAZAKHSTAN: SECRETARY JOHANN'S JANUARY 11 MEETING
WITH HALYK BANK CEO MARCHENKO

1. (SBU) Summary: During a January 11 meeting with Secretary of Agriculture Johanns and his delegation, Halyk

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Bank CEO offered his opinion of the greatest challenges to the country's economic future: in the medium term, the choice of a new Prime Minister and the nature of reforms the new government might undertake; in the long term, diversification of the economy and the 2012 presidential succession. Marchenko described Kazakhstan's mortgage market and private pension system, and identified areas of potential export growth in Kazakhstan's agricultural sector. The former presidential advisor and Central Bank chairman was pessimistic about the prospect of Central Asian economic cooperation, claiming that, economically, Kazakhstan was "looking outside the region." Marchenko gave Kazakhstan high marks for managing its oil revenues, while cautioning that the Chinese were aggressively pursuing additional Kazakhstani oil assets. End Summary.

2. (U) Secretary of Agriculture Mike Johanns met with Grigory Marchenko, former presidential advisor and Chairman of Kazakhstan's Central Bank and current CEO of Halyk Bank, on January 11 in Astana. In addition to Secretary Johanns and Marchenko, meeting participants included Ambassador John Ordway, Under Secretary of State Josette Shiner, Under Secretary of

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Treasury Timothy Adams, Mrs. Stephane Johanns, Deputy Assistant Secretary of State Matthew Bryza, and Jim Loveland (Embassy notetaker).

Identifying Kazakhstan's Economic Challenges

3. (SBU) Ambassador Ordway opened the conversation by asking Marchenko to identify Kazakhstan's major macroeconomic challenges. Marchenko identified two long-term challenges: diversification of the economy ("easier said than done"), and managing the 2012 presidential succession. "We have a good, strong president, he said, "but what will happen in seven years is a wide-open question."

4. (SBU) Marchenko told Secretary Johanns that, in the medium term, the question of who would be the next Prime Minister was important, as were the reforms that the next government would undertake. "We've lost two years of the reform process," Marchenko lamented. "Reforms are harder to come by when oil prices are high." Marchenko explained that, in the competition to attract outside capital, Kazakhstan had to push its reform process faster than Russia's; otherwise the latter would attract all the outside investment. "Due to the reforms Kazakhstan undertook in the 1990s, we're still ahead - especially in the banking sector." However, Kazakhstan lagged behind Russia in education, health care, and culture. Marchenko concluded by listing three other challenges which lay ahead for the Nazarbayev government: fighting corruption, "legitimizing" the shadow economy, and undertaking housing reform. Kazakhstan's construction boom should not be construed as a sign of genuine housing reform, he warned. "What was done was only a billion-dollar interest-free loan to the construction companies."

Characteristics of the Kazakhstani Economy

5. (SBU) Treasury Under Secretary Adams asked Marchenko if Kazakhstan possessed a mortgage market. Yes, Marchenko replied, with two principal instruments - some 15-year mortgages, modeled after Freddie Mac and an Indonesian security; and a large number of 10-year "mortgage lites," offered with an effective 13-14% effective interest rate.

6. (SBU) Marchenko described the Kazakhstani population as "confident in the medium-term" about the Kazakhstani economy, as evidenced by their willingness to hold short- and medium-term securities denominated in the local currency. However, he said, "of deposits longer than three years, 91% are in dollars."

17. (SBU) Continuing his description of the economy, Marchenko noted that in Kazakhstan the ratio of pension assets to GDP was very high, due to widespread employer contributions to pension plans. Marchenko described the rules governing pension fund investments as "fairly liberal," especially a rule which allowed up to 40% of pension assets to be invested abroad.

Dependency on the Oil Economy

18. (SBU) Secretary Johanns asked Marchenko how dependent Kazakhstan's economy was on the current, high price of oil. In reply, Marchenko characterized the GOK's management of oil revenues as "positive," explaining that a cumulative \$7 billion had been saved in the National Fund, both to combat Dutch Disease and to provide for budgetary stabilization. (Marchenko noted that, as Central Bank Chairman, he, along with the then-Minister of Finance, had set up the Fund.) "The Fund could support the budget for two-and-a-half to three years if oil prices went down," Marchenko explained. While money was being set aside, he concluded, little had been done to diversify the economy. The National Innovation Fund and Development Fund, he said, "have made little progress."

Rural Sector Potential

19. (SBU) Asked about the economic potential of Kazakhstan's rural sector, Marchenko replied that exports of wheat, cotton, sunflower seeds and oils, and rice were "positive," and that animal husbandry had "huge potential," especially the raising of sheep for lamb and mutton export. With the country's free pasture, "we could triple the number of sheep we raise." Marchenko also lauded the potential of the food processing and wool processing industries, noting that, unlike the oil sector, these industries generated significant employment. "The potential is big, but success so far is limited."

Growing the Regional Economy

10. (SBU) Under Secretary Shiner asked Marchenko how important the regional economy was to Kazakhstan. "Regional cooperation," Marchenko answered, "is as dead as always." Kazakhstan, he said, was looking outside the region, comparing itself to Russia, Poland, and Hungary. In terms of Central Asia, "the key to the region is Uzbekistan, but they are not interested in cooperation." Marchenko told the Secretary that Halyk Bank had tried to open a branch in Uzbekistan "for five years before I joined," without success. From Uzbekistan, he concluded, Kazakhstan gets only capital flight and illegal labor. President Karimov, he said, is "very smart, but very much into state capitalism." In Uzbekistan, he added, "Stalin is alive." "It's a pity," he said, "because the Uzbek entrepreneurial spirit is good."

Increasing Market Forces in the Energy Sector

11. (SBU) U/S Shiner asked how the U.S. could help increase market forces in the region's energy sector. First, replied Marchenko, "a pipeline through Iran would be good." Second, "try to counter what China is doing." China, he said, "will offer 25% more for oil assets than anyone else...at some point, they will have a really healthy chunk of our market." When Ambassador Ordway noted that the Chinese were not getting "first-line" Kazakhstani oil assets, Marchenko grudgingly agreed: "There are not too many first-line assets left. Still," he said, "your energy policy is not that clear." U/S Shiner responded: "we are clear that the Chinese approach to energy security - actually owning the producing assets - isn't helpful."

12. (U) Secretary Johanns did not have the opportunity to clear this cable.

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